Clients&FriendsMemo

Rightsizing Regulation: U.S. Banking Agencies Release "Tailoring" Proposals and Regional Banks Are the Winners

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Last week, the federal banking agencies issued two notices of proposed rulemaking designed to lessen regulatory requirements on small and regional banking organizations. Together, these two proposals would establish a revised framework for applying prudential, capital, and liquidity standards to large U.S. banking organizations based on risk, consistent with the mandate imposed by Congress in the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Relief Act") enacted earlier this year.[1]

This memorandum provides an overview of this proposed regulatory framework and how it would work.

Tailoring of Prudential Standards

The first notice is a proposal issued by the Board of Governors of the Federal Reserve System (the "FRB") that would "tailor" the application of the so-called "prudential standards" to U.S. bank holding companies, but also would extend enhanced standards to large savings and loan holding companies (other than those substantially engaged in insurance underwriting and commercial activities) as if they were bank holding companies. These prudential standards emanate from Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), and impose requirements on bank holding companies with respect to capital stress testing, risk management, liquidity risk management, liquidity stress testing and liquidity buffer requirements, and single-counterparty credit limits.

Section 165 applied these prudential standards to bank holding companies with assets of $50 billion, and the FRB issued regulations implementing these standards in 2014.[2] Section 401 of the Relief Act raised these Dodd-Frank thresholds to $100 billion effective immediately upon the Relief Act's enactment and to $250 billion by November 2019. However, with respect to bank holding

1 For a summary of the Relief Act, please see our memorandum, "Bank Deregulation Bill Becomes Law," dated May 25, 2018, and available here.

2 *See* 12 C.F.R. Part 252 (Regulation YY).

companies with assets between $100 billion and $250 billion, Section 401 provides the FRB with discretion to apply prudential standards tailored to the risk of the particular firm. In making this determination, the FRB must take into consideration certain factors, including capital structure, riskiness, complexity, financial activities (including financial activities of subsidiaries), size, and any other risk-related factors that the FRB deems appropriate.

Tailoring of Capital and Liquidity Standards

The second notice, issued jointly by the FRB, the Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation, similarly would tailor the application of the agencies' existing capital regulations and liquidity coverage ratio ("LCR") requirements, as well as the proposed net stable funding ratio ("NSFR") regulation.

Neither proposal would apply to the U.S. operations of foreign banking organizations, including any intermediate holding company of a foreign banking organization. However, the FRB plans to develop a separate proposal relating to foreign banking organizations that would implement Section 401 and "reflect the principles of national treatment and equality of competitive opportunity."

How the Revised Framework Would Work

Together, the proposals would establish a revised framework for applying prudential standards (including capital and liquidity requirements) to large U.S. banking organizations, creating four categories of standards for those banking organizations with total consolidated assets of $100 billion or more. These categories reflect the agencies' perception of the differing levels of systemic risks posed by firms in each group:

- *Category I*: U.S. global systemically important bank holding companies ("GSIBs") would remain subject to the most stringent standards, without change, except that the proposal would reduce the frequency of required company-run stress testing from semi-annual to annual.[3]
- *Category II*: Firms of global scale – those with $700 billion or more in total assets or cross-jurisdictional activity of $75 billion or more – would be subject to more stringent prudential standards (based on global standards developed by the Basel Committee on Banking Supervision) and other prudential standards appropriate to very large or internationally active banking organizations.[4] Generally speaking, firms in Category II likely would see no change in existing requirements, but would continue to be excluded from the more onerous requirements

3 Category I would include JPMorgan Chase & Co., Bank of America Corporation, Citigroup, Inc., Wells Fargo & Company, The Goldman Sachs Group, Inc., Morgan Stanley, The Bank of New York Mellon Corporation, and State Street Corporation.

4 Based on current asset levels, Category II would include Northern Trust Corporation.

imposed on GSIBs, such as the Total Loss Absorbing Capital (TLAC) regulation, the GSIB capital surcharge, and the enhanced supplemental leverage ratio capital calculations.

- *Category III*: Firms with $250 billion or more in assets, or with at least $100 billion in assets having "specified risk-based indicators," would be subject to enhanced standards less stringent than those imposed under Category I or Category II, but more stringent than those imposed under Category IV.[5] The three "specified risk-based indicators" would relate to a firm's weighted short-term wholesale funding,[6] its average amount of equity investments in nonbank subsidiaries,[7] and its off-balance-sheet exposures.[8] The FRB did not, however, specify any thresholds within these three risk-based indicators that would trigger Category III treatment, but instead invited comment on the issue.
- *Category IV*: Firms with $100 billion to $250 billion in total assets would be subject to reduced requirements, provided that they do not meet or exceed three specified risk-based indicators warranting their placement in the more rigorous Category III. Firms in Category IV no longer would be subject to standardized liquidity requirements or the requirement to conduct and publicly disclose the results of company-run capital stress tests.[9] Category IV firms would be subject to supervisory stress testing every two years, instead of annually. The frequency of required internal liquidity stress testing would be reduced to quarterly, rather than monthly. Category IV firms would be required to maintain a liquidity buffer that is sufficient to meet the projected net stressed cash-flow need over the 30-day planning horizon under the firm's internal liquidity stress test. For liquidity planning purposes, these firms would be required to calculate collateral positions on a monthly basis, rather than a weekly basis as currently required, and would be required to monitor fewer elements of intraday liquidity risk exposures.

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5 Based on current asset levels alone, Category III would include U.S. Bancorp, The PNC Financial Services Group, Inc., Capital One Financial Corporation, and The Charles Schwab Corporation.

6 "Short-term wholesale funding" is the amount of a firm's funding obtained from wholesale counterparties or retail brokered deposits and sweeps with a remaining maturity of one year or less. Categories of short-term wholesale funding are then weighted based on four residual maturity buckets; the asset class of collateral, if any, backing the funding; and characteristics of the counterparty.

7 "Average total nonbank assets" would mean the average of the total nonbank assets of a bank holding company subject to the capital plan rule, calculated in accordance with the instructions to the Parent Company Only Financial Statements for Large Holding Companies (FR Y-9LP), for the four most recent consecutive quarters or, if the bank holdincompany has not filed the FR Y-9LP for each of the four most recent consecutive quarters, for the most recent quarter or consecutive quarters, as applicable.

8 The proposal would define "off-balance sheet exposure" consistently with measures currently reported by covered firms, as total exposure, as defined on FR Y-15, minus total consolidated assets, as reported on Consolidated Financial Statements for Holding Companies (FR Y-9C).

9 Based on current asset levels alone, Category IV would include BB&T Corporation, Suntrust Banks, Inc., American Express Company, Ally Financial, Inc., Citizens Financial Group, Inc., Fifth Third Bancorp, KeyCorp, Regions Financial Corporation, M&T Bank Corporation, Huntington Bancshares Incorporated, and Discover Financial Services.

The proposal would largely maintain the existing capital planning and stress testing standards under the capital plan and enhanced prudential standards rules for Category III firms, but would remove the mid-cycle company-run stress testing requirement and require public disclosure of company-run stress test results every two years, instead of annually. In addition, a Category III firm would be required to submit an annual capital plan and be subject to the qualitative and quantitative assessment of its capital plan through the Comprehensive Capital Analysis and Review (CCAR) process. Category III firms would be subject to annual supervisory stress testing, and would also be required to conduct an internal stress test in connection with its annual capital plan submission.

Category III firms would not be subject to advanced approaches capital requirements or the requirement to recognize most elements of accumulated other comprehensive income in regulatory capital. Instead, they would be subject to U.S. generally applicable risk-based capital requirements, including capital buffers, as well as the U.S. leverage ratio and the supplementary leverage ratio. The FRB would maintain the existing liquidity risk management, monthly internal liquidity stress testing, and liquidity buffer requirements under the enhanced prudential standards rule for firms subject to Category III standards. Such firms also would be subject to tailored LCR and NSFR requirements based on whether the firm has $75 billion or more in weighted short-term wholesale funding.

Consistent with the requirements of Section 401, firms with assets below $100 billion are exempt from the prudential requirements.[10]

As an alternative to the threshold-based approach described above, the FRB has requested comment on whether it should use the GSIB risk scoring methodology under its GSIB surcharge rule to determine the applicable category of standards for banking organizations with $100 billion or more in total assets.

No Change in Living Wills – For Now

The tailoring proposals would not alter existing requirements with respect to resolution planning, or "living wills," mandated by Section 165(d) of Dodd-Frank for bank holding companies with assets equal to or greater than $50 billion. However, the FRB intends to issue a separate proposal that would tailor the resolution planning requirements for firms with total consolidated assets in the range of $100 billion to $250 billion.

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[10] These firms include Synchrony Financial, Comerica Incorporated, E*TRADE Financial Corporation, SVB Financial Group, and New York Community Bancorp, Inc.

If you have any questions, please feel free to contact the following Cadwalader attorneys.

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